

## **REAL ESTATE ADVISOR AUGUST 2008**

### **THE NEW GREEN STANDARD WILL HELP REMODELERS**

There's a new resource for residential developers and building owners looking to reap the financial, tax and goodwill benefits of going green. The American Society of Interior Designers (ASID) Foundation and the U.S. Green Building Council (USGBC) recently released the nation's first sustainable residential remodeling guidelines.

#### **Green guidance**

The REGREEN program ([regreenprogram.org](http://regreenprogram.org)) offers best practices, educational programs, and print and electronic resources for residential designers, construction professionals, product developers and homeowners. The Web site also provides case studies, product information and workshops for developers and homeowners.

REGREEN is a response to construction market trends over the past decade — in particular, the fact that residential remodeling has represented a substantial portion of this sector. Whereas green guidelines generally have been geared to *new* construction, REGREEN's 182-page guidelines set out steps for interviewing clients about remodeling projects, evaluating the building, and creating an integrated team of professionals. Plus, they detail material, design and strategic options for ten different types of remodeling projects.

#### **Green Web site**

According to REGREEN's Web site, some 30 million homes have been remodeled in the past 10 years, representing 10% of the collective value of homes nationwide. Residential remodeling offers an excellent opportunity to address environmental, economic and health concerns in this construction segment. Builders can incorporate green into their remodeling by choosing energy-efficient designs and using renewable, recyclable and environmentally friendly materials.

From a developer's or building owner's standpoint, adhering to green practices when remodeling residential properties has clear financial and health benefits. For example, according to the USGBC, using green building design on new or remodeled projects can save up to 12% on water usage, 65% on wastewater generation and 71% on electricity, reducing building operating costs by 8% to 9%. It can also increase building value by 7.5%; investors' rate of return by 6.6%; occupancy rates by 3.5%; and rental rates by 3%.

A 2007 study by the United Nations Environment Programme found that, by going green in remodeling and new construction, the building sector could reduce CO<sub>2</sub> emissions by 1.8 billion tons worldwide.

Developers of this new comprehensive set of guidelines geared to residential remodeling hope this building segment will gain attention similar to that of the increasingly popular practice of environmentally friendly new construction.

#### **Green benefits add up**

If you're not yet convinced of the merits of green development, consider how going green can help your business's reputation in your community and help you tap into a growing market niche, both of which relate to your bottom line.

Also, most states offer tax breaks for green development. And the federal government offers tax incentives for owners of buildings that qualify for Leadership in Energy and Environmental Design (LEED) ratings. And, finally, customers and clients are looking for developers to incorporate environmentally friendly features. In fact, using green designs for lighting and fresh air may increase tenant demand for your properties and can result in higher rental income and purchase prices.

The USGBC also notes that investments in environmentally friendly building technologies pay for themselves within a few years. Adding to the attractiveness of remodeling green is the fact that there are more and more green building materials on the market. Prices on these materials have decreased as options have expanded.

### **Go green, make greenbacks**

With all those dollars-and-cents reasons to go green, it's worth your while to incorporate more green practices into your building and remodeling projects. The REGREEN Web site includes information to help you get started.

### **More incentive for going green**

The IRS recently clarified and expanded advice about regulations that allow commercial building owners to deduct part or all of the cost of installing equipment designed to make their property more energy-efficient.

IRS Notice 2008-40, a clarification of Notice 2006-52, states that a deduction is available when an owner installs property as part of the building's heating, cooling, ventilation, hot water, or interior and exterior lighting systems, and then gains certification that the building meets federal energy efficiency requirements.

The regulation applies to buildings placed in service after Dec. 31, 2005, and before Jan. 1, 2009. It also includes a provision allowing federal, state or municipal governments to extend deductions to designers of energy-efficient systems for public buildings.

## **TURBULENCE IN THE REAL ESTATE MARKET**

### **What to do in the meantime**

Is the current real estate market making it harder to sell your commercial property? Beefing up your leasing strategies could help you weather the storm until the selling climate improves.

### **Commercial winds holding steady**

According to the National Association of Realtors (NAR), the commercial real estate market is holding steady with near-full occupancy levels and stable rental rates. While that would normally mean strong interest by investors looking to buy, NAR Chief Economist Lawrence Yun notes that the credit crunch is causing buyers to sit on the sidelines, at least for the time being.

In the meantime, property owners can expect a relatively stable environment in which to wait it out.

What do such forecasts mean to you? Simply put, you'll need to change your thinking about commercial leasing strategies.

### **Sunny skies in certain areas**

As with any aspect of real estate, it pays to do your homework on your property's particular market. Some areas are more competitive than others and you may want to step up your marketing tactics and positioning efforts accordingly. For example, get competitive in locking in deals for commercial tenants. Offer free rent for a period, tenant improvement allowances or shorter leases for tenants seeking more flexibility.

Plus, focus on particularly successful niches, such as medical office buildings, college student housing and retirement communities. (Also see "Thriving markets are out there".)

### **Tools of the trade**

As you sharpen your focus on a target tenant market, so too should you sharpen your knowledge of the various lease structures. There are several types of commercial leases you can use:

**Gross leases.** Probably the most common, a gross lease is structured so the tenant pays a set rental fee and the landlord is responsible for taxes and other property expenses. A "subset" of gross leases consists of those that charge the tenant a set amount for rent plus utilities, with any

overage on those utilities, taxes, insurance and utilities for common spaces being picked up by the landlord.

**Net leases.** These provide for the tenant to pay a set fee plus a portion of expenses for insurance, property maintenance and other costs.

**Triple net leases.** Under this type of lease, the tenant pays rent as well as all expenses associated with the building. If you're renting to a retail tenant, your lease may also include payments based on a percentage of sales.

Before pursuing any of these types of lease agreement, talk with your financial and real estate professionals.

### **Forecasting tricks**

As you begin to negotiate with would-be tenants, cover all the basics. For example, performing due diligence ahead of time is essential to working out lease terms that won't prove costly down the road. For instance, how will your lease provide for changes in the local tax structure or regulatory climate that could impact you and your tenant? How will the property use that the tenant is proposing affect the property's long-term value?

Also, carefully evaluate prospective tenants' financial standing to determine whether they're able to meet the terms. You can get information on public companies via a number of sources, including SEC filings and the Internet. For privately held companies, consider a fee-based tenant underwriting service.

When structuring your commercial lease, make sure you include provisions regarding the term of the lease, permitted uses for the property, tenant improvements, and maintenance and repairs.

### **Smooth sailing**

In the current market, finding the right tenant and structuring an airtight lease can provide you with the secure income you need to weather the current market slowdown. But don't set sail alone; contact your real estate and financial advisor.

#### **A 1031 exchange may provide help in a down economy**

An Internal Revenue Code Section 1031 exchange (also known as a like-kind exchange) could help you survive the current economic slump, while boosting the larger market by freeing up equity. In effect, you can use a 1031 exchange to trade up and defer taxes at the same time.

With a 1031 exchange you can defer the gain on real or personal property used in a business or held for investment if, instead of selling the property, you exchange it for property of a "like kind" — that is, property of the same asset or product class for personal property, or virtually any type of real estate if it's business or investment property.

To qualify for tax-deferred treatment, you must identify replacement property within 45 days after you sell the relinquished property. Then you must complete the purchase within 180 days after the initial sale. As always, consult your tax advisor when entering into this type of arrangement to make sure it's structured correctly to protect your interests.

### **THRIVING MARKETS ARE OUT THERE You just need to know where to look**

Despite the recent economic doom and gloom, commercial real estate developers and investors can still find market segments and geographic areas that continue to show promise. Here are some markets you may have overlooked.

### **Renters on the rise**

Multifamily housing continues to be buoyed by the subprime home mortgage crisis and ensuing foreclosure landslide. As thousands of people lost their homes in the past two years, they turned to the rental market to put roofs over their heads.

According to a study released this year by the National Multi Housing Council (NMHC), the number of people renting housing nationwide is expected to increase by 4.3 million households over the next decade. In the last two years, more than one million households became renters. NMHC predicts that apartment demand will increase by 430,000 units a year over the next decade, adding to the 16 million households that currently rent.

Of course, if you're a multifamily investor or developer, you'll need to evaluate the specific market you're considering. Look for cities with strong population and job growth, such as Portland, Ore. and San Francisco, Calif., which have vacancy rates in the 4% range. Other strong multifamily markets include Austin and San Antonio, Texas; Chicago, Ill.; New York City; Seattle, Wash.; and Washington, D.C.

### **Industrial-strength opportunities**

The National Association of Realtors (NAR) has singled out industrial space as a key bright spot for 2008. In this case, the weak dollar — which is boosting domestic manufacturing activity — and increased global trade activity are strengthening the demand for industrial space. Rental rates for this space, particularly warehouse facilities on the coasts, have been spiking and vacancy rates have been declining nationwide over the past two years. The NAR notes that, in addition to growing import volumes, research space is in demand by thriving technology companies.

Among the hot industrial markets in the United States cited by commercial real estate information firm CoStar are the Inland Empire, Calif. (a region just east of Los Angeles, comprising several cities in Riverside and San Bernardino Counties). In addition, Chicago, Ill.; the Dallas–Fort Worth area and Houston, Tex.; Portland, Ore.; Salt Lake City, Utah; San Jose, Calif.; Seattle, Wash.; and Tampa, Fla., boast thriving industrial markets.

### **Sunnier overseas markets**

From Norway to Vietnam, overseas investment opportunities still abound, provided investors do their homework and make careful choices. In Europe, for example, several countries with growing economies are experiencing double-digit rent increases for office space, according to the 2008 NAI Global Market Report. Countries such as Hungary, Norway, Poland and Spain and cities such as Moscow and Paris are among the hot spots.

While the retail segment in the United States is facing decline as consumers react to the economic downturn, there's a pent-up demand for consumer goods in Mexico. Investors are also looking to tap into the growing office and industrial market in Canada.

The International Monetary Fund's gross domestic product numbers highlight the world's most-promising economies. While the U.S. GDP edged up 1.9% in 2007, Argentina saw a 7.5% jump, China, 11.5% and Vietnam, 8.3%.

### **Explore the options**

From multifamily housing to industrial space to overseas markets, bright spots do abound for investors willing to expand their horizons and look for them. But proceed with caution: Even though these areas are flourishing now, performing due diligence is critical, particularly in overseas markets.

## **TAX CREDITS REWARD LOW-INCOME HOUSING INVESTORS**

Affordable housing is often viewed as a less-than-attractive investment option fraught with excessive government rules and regulations. But many developers and investors are finding that such potential headaches are offset by the financial rewards of the federal low-income housing tax credit program (LIHTC).

Established in 1986 and administered by the IRS, the LIHTC program provides tax credits to private developers who agree to set aside housing units for low- and moderate-income families. Developers sell the tax credits to investors to raise capital to finance their projects. LIHTC buyers essentially invest in a stream of tax benefits, taken over 10 years (though deemed earned over 15 years), based on the supporting real estate asset. The credits are applied dollar-for-dollar to reduce an investor's federal income tax liability.

The federal government issues some \$5.1 billion a year in such credits, accounting for about 90,000 units of low-cost housing per year, according to Harvard University's Joint Center for Housing Studies.

In recent years, LIHTCs have not only been an effective incentive for developers to create low-income housing, but they've also been in brisk demand by investors — including large institutions and lenders. Whether that demand will decrease given recent changes in the capital markets remains to be seen. The recent housing slump and credit crunch could cause some large LIHTC investors to curtail their investments in light of reduced revenues and tax liabilities.

LIHTCs have been supply-constrained in recent years as more investors have found them desirable and the number of developments generating them hasn't kept pace. Such a slowdown, however, is likely to create more balanced tax credit pricing rather than blemish their appeal for investors. That said, developers can expect to find the average price per credit dollar to drop in 2008 as that balancing in the marketplace occurs, and should plan accordingly when putting together their transactions.

Developers seeking tax credit investors for their projects should expect prospective buyers to scrutinize the structure and underwriting standards of the deal. The Affordable Housing Investors Council ([ahic.org](http://ahic.org)) offers guidelines that include performing background checks on the developers, regularly visiting the project site and reviewing developer financial statements. It advises investors to apply similar due diligence to the project's property management.

## **ASK THE ADVISOR**

### **How will debt forgiveness tax relief ease the mortgage crisis?**

The Mortgage Forgiveness Debt Relief Act of 2007, which became law last December, was enacted to help stem the snowballing foreclosure and economic landslide brought on by the subprime mortgage crisis of the past several years. Although beleaguered homeowners were perhaps the first to experience the onslaught, the snowball effect has swept up real estate investors, developers and lenders as well.

#### **What the law does**

The new law creates a three-year exception (from Jan. 1, 2007, through Dec. 31, 2009) to current law so that affected homeowners won't have to pay federal income taxes on debt forgiveness on their troubled loans. This provides relief to homeowners who receive debt forgiveness in a foreclosure or in a mortgage workout, under which the terms of the mortgage are changed, resulting in a lower mortgage balance.

The law specifically applies to mortgages on a principal residence — not to vacation or secondary homes. The law also doesn't apply to homeowners in Chapter 11 bankruptcy. What's more, the law extends (through Dec. 31, 2010) a 2006 provision that allows taxpayers to take an itemized deduction for premiums paid or accrued on qualified mortgage insurance.

Prior to the mortgage relief act, if a distressed homeowner sold a house for less than the mortgage obligation in a so-called short sale, any difference between the mortgage balance and the sale proceeds that was forgiven was deemed income by the IRS. The homeowner was taxed on that difference as earned income. The same tax applied when the homeowner faced foreclosure and a portion of the mortgage debt was forgiven by the bank in the process.

### **Banks can tend to banking**

The law is also helping increase the number of short sales of distressed homes, keeping them off banks' rosters of homes they've taken back and must manage. That means banks won't incur the expense of holding and managing real estate.

It also means that more homes targeted for foreclosure can instead be sold at low prices to first-time homebuyers. Those buyers become mortgage customers and can aid the real estate market recovery.

### **The bottom line**

The mortgage relief act encourages homeowners and lenders to work together to avoid foreclosure by either structuring manageable payments or selling the property for less than is owed on it. It's an important step toward stemming the tide of home foreclosures and, possibly, putting the subprime mortgage crisis behind the housing real estate market. And that, hopefully, will help lead to a more favorable housing market for everyone.

## **FOR FURTHER INFORMATION**

If you have any questions, please contact **Harry Moehringer, CPA, Partner-in-Charge** of the Marks Paneth & Shron LLP Real Estate Services Group at 212-503-8904 or [hmoehringer@markspaneth.com](mailto:hmoehringer@markspaneth.com).

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